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Brent Sheather's RESEARCH

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Private Equity: The Tyranny of IRR: Part 4 – Retail Investor's Private Equity Investments Will Likely Underperform

Today, in this fourth part in this series of private equity we will hear from some independent experts on the relevance of private equity to retail investor portfolios. We will go through those issues later but first we need to observe the actual reality of how private equity offers are allocated both locally and overseas and speculate that, in contrast to the public markets, institutional investment in PE is likely to diminish the returns of retail investors rather than assist them.

Reality of the PE world in NZ and overseas is that there is a wide variation in the performance of PE managers with the result that it is often difficult to buy into funds run by those few with the best track records. Allocations in these usually go to big institutions, like the NZ Super Fund in NZ whose presence on the share register assists marketing efforts, and various insiders and friends of the manager/broker to the listing. Cue conflict of interest warning. Conversely it is very easy to buy poor performing funds like, for example, Maui Capital a few years back. The same sort of thing happens, with much less impact in terms of performance, in the public markets where allocations to attractive IPOs go to the brokers' most valuable clients but bad ones get sub-underwritten by DIMS clients'. This unfortunate reality, as it applied to hedge funds some 20 years ago, led one cynical investor to comment in the Financial Times that "I wouldn't buy any hedge fund that I was able to get access to". In a recent commentary on the PE sector a US personal finance publisher, Kiplinger, founded in 1920, made the same point: "*the gap between top-quartile and bottom-quartile private funds is enormous. Institutions spend millions identifying the best managers. Retail investors get what's left.*"

In New Zealand the bifurcation between good and bad continues in the secondary markets where there are typically no buyers for the PE funds which were easy to buy and no sellers for the funds that were hard to access. Overall the secondary markets for private equity in NZ are pretty much non-existent so investors have no real idea what their investments are worth even if they could sell them. This secondary market illiquidity is compounded by the fact that new PE funds often pay higher rates of commission etc than can be achieved in the secondary market. Cue another conflict of interest warning. There is little in the way of informed price discovery in the secondary market, except for some insider trading, so the only intimation of what a PE investment might be worth is the stated NAV but these numbers are often stale and occasionally completely out of touch with reality. The downside of the fact that you can't sell your PE exposure was brought home to me a few years back when a new client came to our firm with $500,000 in various local private equity funds and then needed to realise half of her retirement portfolio to purchase a new house. Because we couldn't sell any of her private equity funds we had to fund the $1.0m from things we could sell and after those sales PE constituted about 40% of her portfolio making it extremely high risk. Kiplinger also quotes the CFA Institute as saying "Private markets remain inappropriate for most retail investors due to illiquidity, high costs and limited transparency.

A further big problem for retail clients investing in private markets is the asymmetry in terms of information and disclosure as regards the public and private markets: when one assesses the attractiveness of the New Zealand or world stockmarkets it is reasonably easy to find data on long term historic average returns but no such data is available, as far as I know, on the NZ private equity scene. We have all read about the outstanding performances of companies like Halter, Crimson etc but unsuccessful PE investments generally don't make the headlines. We can thus only speculate on the overall performance of NZ PE but, as research by Professor Henrik Bessembinder has highlighted in respect of the public markets, overall performance in that asset class has been due to the outstanding returns of a small number of companies. It is quite possible that the same dynamics occur in the local PE scene so the fact that it is difficult to get access to the big hitters means that the average retail investors' experience with PE could be quite disappointing relative to what the overall market has done. Disclosure is a further issue: Whereas just about everything is publicly available to investors, large and small, participating in the listed markets the opposite is the case in private equity. In fact many of the annual and interim reports I have seen from local PE funds contain a warning that if you publish anything without permission you risk legal action. To actually get information you need to either own the fund or have a client that owns that fund and even then, unless the news is good, you can't tell anyone! Back in the '90s UK economist, Andrew Smithers, noted that the first rule of "stockbroker economics" was that "all news is good news". Local PE reporting constraints take that reality to the next level.

As noted earlier, after months of lobbying by PE managers, 401K sponsors will shortly be able to include private assets in American retail investors' savings portfolios, thanks to President Donald Trump signing an executive order to this effect. This is a major development for American financial markets and its prospect has prompted a number of unconflicted experts to urge caution. Recently Professor William Clayton, Professor of Law at Bringham Young University Law School and Professor Elisabeth de Fontenay of Duke University Law School, writing in the London Financial Times, said "*With a green light imminent from the Department of Labour and the Securities and Exchange Commission, we are staring down the barrel of one of the most significant changes in recent history to the design of US capital markets and of the US retirement system.*"

Professors Clayton and de Fontenay highlight a critical difference between the private and public markets as they relate to your average naïve retail investor: "*It's worth remembering why US retail investors have thrived in the public markets for the last half-century. Thanks to the magic of index funds, retail investors can freeride on the efforts of institutional investors and get the same market return as everyone else, at near-zero cost. By contrast, there is simply no way to "index" the private markets. Even the most sophisticated investors in private funds get wildly different returns from one another — hardly an attractive prospect for 401(k)s. So while it is true that pension funds already routinely invest in private equity and venture capital funds, many do far worse in these markets than public-market indexers. How will 401(k) investors fare, by comparison? 401(k) plan managers are notoriously bad at selecting actively managed funds in public markets. Private funds layer on high (and opaque) fees that eat into gains. And no one has explained how 401(k) investors would get in and out of illiquid investments that rarely face objective valuations. So even if retail investors could replicate the industry's historical average returns, it's unclear whether those returns would meaningfully improve their risk-adjusted outcomes compared with public-market exposure. A massive influx of 401(k) money would only drive returns down further — a classic "money chasing deals" problem. This would be an especially bad* *time to usher 401(k) investors into private markets and private funds. The market is already saturated with institutional money, and a multi-year bottleneck in deals means that private equity and venture capital funds are struggling to turn their holdings into cash. Instead, sponsors are resorting to continuation funds — selling assets from one fund to a new fund they also manage, essentially flipping assets in the absence of an exit to an external buyer while they continue to collect fees. In short, private markets today are not only bloated and illiquid, but also rife with conflicts of interest. There may be rational ways to bring 401(k)s into the private markets eventually, but this is neither the time nor the way to do it".*